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"The international lending of the 1980s created an illusion of soundness and stability which did not exist. So long as the flow of funds continued, the cracks in the international economic structure remained concealed. But at the same time the lending widened the cracks so that once the flow was cut off, the system was undermined completely."

D.H. Aldcroft, From Versailles to Wall Street 1919-1929
p. 245, Penguin Books, London

HIGHLIGHTS

The most striking characteristic of world financial markets presently is the heterogeneity in the behaviour of domestic markets and currencies. Seldom have there been such tremendous contrasts between the economic and financial positions of the major countries.

World capital flows are currently revealing the eddies and turbulence of a tremendous tide reversal. Capital outflows are being pulled back to their source. The deficit countries are least able to withstand the related loss of liquidity.

A rising yen indicates that Japan's huge excess investment flows into the rest of the world's securities markets have suddenly dried up. What would happen if Japan had to sell portions of their large holdings of international securities (that being primarily U.S. bonds) in order to raise liquidity?

We haven't the slightest doubt that capital account effects - falling German outflows and rising inflows - will dominate to boost the D-mark over the long run. It all comes down to whether the Bundesbank keeps monetary policy sufficiently tight.

The dollar's failure to respond positively to the Middle-East crisis foreshadows serious impending weakness.

Every single part of the U.S. economy has been in a major slowdown for more than a year without so much as being recognized. We see every potential for a cumulative slowdown with little in sight to stop it.

An already runaway U.S. fiscal deficit thrusts the task of staving off or allaying a recession solely and squarely on the shoulders of Mr. Greenspan and the Fed . . . in other words, monetary policy.

If the recession deepens and distress signals from the banking system reach a feverish pitch we must assume that the Fed will have no choice. It will be compelled to scrap its anti-inflation stance, easing openly and aggressively, irrespective of the consequences for inflation and the dollar.

SEA CHANGE IN CAPITAL FLOWS AND CURRENCIES

While the Iraqi invasion of Kuwait may have shaken the world financial markets, the event must certainly be considered more of a catalyst than the architect of the tremors. It only takes a mild wind to topple a house of cards, whether tall or small. In this case, the steepness of the reaction had more to do with the elevation.

The most instructive and striking characteristic of world financial markets presently is the heterogeneity - not the homogeneity - in the behaviour of the home markets and currencies of the various countries. Obviously, some economies, currencies and markets are more vulnerable than others to the Iraqi situation and the resultant rise in oil prices. However, it's not the differences in the minor econometrics that's our focus here. The fact is that seldom have there been such tremendous contrasts between the economic and financial positions of the major countries.

CONTRASTS AS NEVER BEFORE

In Continental Europe, the financial rout was basically confined to the share markets. Otherwise, the Continent proved to be a quiet rock of relative stability in the eye of the storm. Buoyant economies combined with strong currencies - led by the D-mark's inexorable rise against the U.S. dollar - and stable bond markets helped weather the sudden tempest.

This stability is particularly remarkable in the case of the German bond market, which, in addition to the oil price hike, has to digest sharply increased public borrowing in order to meet the escalating costs of reunification. Yields of 9%, however, continue to attract domestic investors, en masse.

The situation in the United States, however, contrasts quite differently. It faces an economy that hovers on the edge of recession, a stubbornly high inflation level even before the push of higher oil prices, and an ugly inescapable bear market everywhere including stocks, bonds, real estate and the dollar. All are down sharply.

Completely different again is the situation in Japan and other surrounding parts of the Far East and Pacific Rim. On the one hand, economies are still advancing in real terms of 5% or more; on the other hand, however, inflation worsens, interest rates continue to rise and stock, bond and real estate markets literally collapse. In short: a striking dichotomy between economic buoyancy and financial attrition.

Of course, many analysts like to stress that the world economies, and especially the capital markets, are becoming increasingly interlinked. That is true. But, nevertheless, the crucial point to realize is that the economic and financial conditions of the major countries have never been so extremely diverse as today.

Given these tremendous contrasts around the world, the great question is how they together will convene to impact currencies, international asset markets and the economies.

Three issues and their uneven effects cast their shadow. As we see them, they include:

- A U.S. recession . . . or worse?
- Financial debacles in Japan.
- German economic unification (Gemu).

Above all, one thing gives these three situations eminent importance. That is the potentially vast implications for international capital flows that each of these situations could trigger. After all, international capital flows have proven to be the dominant influence on currency movements. In combination, they set the stage for a tide reversal in international capital flows and consequently for a sea change in currency values.

COMMON CASUALTIES: U.S. BONDS AND THE DOLLAR

As far as the United States is concerned, two occurrences have come as the greatest surprises and shock to the financial markets. One is the tattering of the U.S bond market and the other is the battering of the U.S. dollar. While the drop in the dollar may be more readily comprehensible to most, many are at complete wits end to explain the bond market decline.

For wall Street, it had been a foregone conclusion that a weakening U.S. economy would be the sure recipe for falling short and long-term interest rates. Both had been expected to fall in tandem. In this respect, the developments in the second half of the year had been most encouraging. As the Fed eased, allowing the Fed funds rate to fall from nearly 10% to 8.25%, long-term bond yields declined from approximately 8.5%-8.75% to less than 8% by year-end 1989. Euphoric forecasts of further declines to 7% abounded.

Since then, the U.S. economy has proved to be much weaker than expected. A further monetary weakening looked to be more certain than ever. But instead of responding favourably to this sure-fire outlook, long-term bond yields shot up to around 9% first during April and again in late August and early September. Something went awfully wrong. Was it something temporary and quixotic or something with more profound causes? The answer is found in the present-day nature and cumulative structure of international capital flows.

A surprise has also taken place internationally. There, for most people, the greatest shock has been the calamitous plunge of the dollar not only against the D-mark but lately also against the yen. Even the old standby that always served to benefit the dollar in times of crisis - namely, the safe-haven prop - seems to have gone awry.

Here, too, the consensus (especially outside of America) had been overwhelmingly bullish (and even now couldn't yet be considered outrightly bearish). Most people simply fail to understand the dollar's collapse. After all, wasn't the dollar underpinned by the world's biggest economy and already unbelievably cheap? The answer to the weak dollar can again be found in the structure of international capital flows, a topic we'll delve into deeper.

IMPACT OF A RECESSION ON THE DOLLAR

Another disputed issue over currency movements has been the potential impact of the impending U.S. recession. Until recently, it was widely held the dollar would tend to be buoyed by a recession through two channels: first, through an enhanced improvement in the trade balance; and second, through rising capital inflows that would be lured from abroad in prospect of rich capital gains on U.S. stocks and bonds in a climate of easy money.

Our letters have consistently warned against this assumption. We have always implied that the idea that a recession in the United States tends to strengthen the dollar defies all logic and historical experience. In fact, both argue the exact opposite effect. A U.S. recession has always led to a weak dollar because the U.S. capital account, under the influence of easier money, generally deteriorates much faster than the current account improves thereby depressing the dollar at this stage in the business cycle. Not only that, but dollar weakness becomes particularly pronounced the sharper the cyclical mismatch. That happens when the U.S. recession coincides with boom conditions in Germany and Europe.

HOW LOW CAN THE DOLLAR FALL?

Any discussion of the currency situation inevitably brings up the question, "How deep can the dollar fall yet?" The straight forward answer is that there is neither a ready answer nor predetermined level. It depends on a whole host of influences inside and outside of the United States. To be more explicit, it depends on the relative economic, financial and cyclical developments between the major countries. Taken from that perspective, currencies are moving targets.

Surveying numerous bank and broker reports recently, we noted anything but a sense of anxiety over the dollar. Given the swift fall, there is now a general bearishness. However, it seems that any bearishness is strictly limited to the short-term outlook. Most commentators continue to stress good and improving fundamentals for the intermediate-term outlook. In fact, we notice a virtual consensus in favour of a dollar recovery to DM 1.70 or more by next year.

THE IDEAL SCENARIO

For us, these predominantly rosy forecasts for the U.S. dollar over the next year harbour another important message. Such optimism over the currency essentially requires a rather optimistic set of assumptions about the outcome of the impending recession. To accommodate these currency forecasts, the recession would have to be mild and brief and to be followed thereafter by a full recovery beginning well before mid-1991.

No doubt, a mild, brief recession would be ideal for the U.S.economy as well as for the world economy and the dollar, although not for U.S. inflation. There is one snag, however. This scenario is grossly unrealistic. More clearly than anything else, these forecasts confirm to us how many people are still dreaming.

Again back to the hot seat: How low is low for the U.S. dollar? The answer is that the danger of a dollar crisis rises in proportion to the length and depth of the impending U.S. recession. The worst possible scenario would be a slumping economy that forces the Fed to ease aggressively regardless of inflation levels and its contributing factors. Potentially, it could well mean a dollar collapse from virtually any level.

Essentially, such considerations first of all have to begin with the question of how weak and vulnerable the U.S. economy is. The second crucial variable, then, is the likely response of the Fed. As to the first question, the table on the top of the next page gives some

perspective of the depth and breadth of the U.S economy's downturn, a downturn that already began early last year.

U.S. GROSS NATIONAL PRODUCT
(In constant dollars, % changes at annual rates)

	1987	1988	2Q 1990*
Real GNP	3.4	4.5	1.3
Personal Consumption	2.8	3.6	1.2
Durable Goods	1.8	6.8	1.0
Nondurable Goods	1.7	1.9	-1.1
Services	4.0	3.8	2.9
Nonresidential Fixed Inv.	2.6	8.3	1.5
Structures	-5.6	-0.3	-0.8
Plant and Equipment	6.1	11.6	2.3
Residential Investment	0.4	-0.8	-5.1
Exports	13.8	18.3	6.4
Imports	8.2	7.1	5.2
Government Spending	2.3	0.2	2.7

* Represents running four quarters to end of second quarter 1990.

What the above table shows with unsurpassable clarity is that every single part of the U.S. economy has been in a major slowdown for more than a year without being so much as recognized.

In sum, the economy is much weaker than most expected. Important as this recognition is, the far more important question concerns the nature of the underlying causes. Similarly, one must also determine whether these same causes are still at work, thus threatening to turn weakness into a cumulative downturn.

MALADJUSTMENTS AS NEVER BEFORE

In reality, the difference between 1% or zero growth is a triviality. What is an important difference, though, is a mild versus a severe recession. Our perception in this respect is strongly influenced by a principle that used to be conventional wisdom among economists as formulated by Gottfried Haberler in his "Prosperity and Depression" of 1937. We quote: *"The length and severity of depressions depend partly on the magnitude of the "real" maladjustments which developed during the preceding boom and partly on the aggravating monetary and credit factors."*

Putting it differently and perhaps more pointedly, assessing the inflation risks, we have to look out for two things: firstly, maladjustments in the real economy and the income structure; and secondly, complications and constraints in the monetary, fiscal and private financial sphere.

On both accounts the fact is that the underlying conditions in the United States are more precarious than ever before. It's really a joke when American economists speak of a well balanced economy, merely because large inventory excesses are not present pre-recession. The irony is, instead, that just about everything else has gone to excess.

A vast array of economic and financial maladjustments are now choking growth both from the supply side and the demand side of the economy. The symptoms of these conditions are found in slumping real estate prices, sharply lower personal income growth, an exhausted and over-leveraged consumer, a rapidly deteriorating employment picture, an again exploding budget deficit, unprecedented debt burdens, financial distress among state and local governments, the morass besetting financial institutions plagued by bad loans to lesser developed nations, real estate and LBO's, and a trade deficit of still around $100 billion. In our view, that is more than enough to bring on a recession and a nasty one at that.

On sum, we see a whole barrage of depressing influences choking economic growth, Not only that, all of them are worsening with the exception of the trade balance. Given this wide range of increasing economic and financial stresses, it appears pretty sure to us that this is a downturn with cumulative dynamics and that there is nothing in sight so far that can stop it.

EXPORTS: FUTILE HOPES

Where are there any countering and stabilizing influences? In 1987-88, the U.S. economy was rescued from the threat of recession by surging exports driven by booming economies in Europe and the Far East. Now again, hopes for a new export boom are a major assumption behind the forecasts of a mild, brief recession and a stronger dollar. Futile hopes.

The fact is that U.S. export growth has slowed substantially in the past year, and it's easy to see why. One reason is that world economic growth in general has peaked. Another reason is that the geographical mix of U.S. exports is heavily skewed towards weakening economies. There is, though, much ado about the improving trade balance with Europe. But here one must realize that Continental Europe only accounts for 23% of all U.S. merchandise exports. Overwhelmingly, U.S. exports are much more leveraged to those countries with weakening economies. Alone over 35% of exports go to three countries on the verge of recession: Canada, Mexico and Britain.

GREENSPAN'S DILEMMA

What else could stem the U.S. economic downturn? Fiscal policy? The budget situation is already a disaster before any recession has started. The first 10 months of the fiscal year have already produced a deficit of $189.1 billion. Including the costs of the thrift industry bailout and the military build-up in the Middle East, the total will probably reach or exceed $230 billion this year. A recession could easily boost next year's deficit to $300 billion and higher.

Such a fiscal situation puts the task of staving off or allaying a recession solely and squarely on the shoulders of Mr. Greenspan and the Fed . . . in other words, monetary policy. But to top it all, the Federal Reserve itself is also confronted with an unprecedented calamity.

This time, the Fed has to cope with five significant and incompatible risks, each of which could spell disaster for the U.S. economy, its markets and its currency. These are (1) inflation at 5% and still rising (2) recession, (3) inordinately high debt levels, (4) a looming bank crisis (5) and a dollar collapse.

The incompatibility of these risks make for serious trouble. High inflation and a weak dollar requires tighter money. Economic and financial weakness requires easier money. Any pronounced move threatens serious adverse repercussions which ever way. A monetary easing -- in particular an expectation of a progressive easing -- is likely to provoke a plunge in the dollar and a sell-off in the U.S. bond market, thus driving up long-term interest rates. By contrast, any monetary tightening would deal a crushing blow to the economy and threaten a bank and debt crisis.

Confronted with these extremely conflicting policy requirements, the Fed has chosen to ease more slowly than usual, earning itself thereby the reputation of a staunch inflation fighter. But doing so, of course, raises the risks of recession over time.

How long can the Fed stick it out with its cautious policy stance? That's the decisive question. The dominating perception in the markets, obviously, is that the Fed would never compromise its hard-won anti-inflationists credibility because it might spell disaster for the dollar and the U.S. bond market.

But what if the recession deepens, unemployment rises and distress signals from the banking systems reach a feverish pitch? It is our assumption under such circumstances that the Fed will have no choice. It will be compelled to scrap its anti-inflation stance, easing openly and aggressively irrespective of the consequences for inflation and the dollar.

DOLLAR WITHOUT INTEREST RATE SHIELD

Last but not least, there is yet another very important reason why the U.S. dollar is more vulnerable today than ever before: it has lost safety shield that had protected earlier . . . the shield of relatively high interest rates. See the following table on the opposite page showing the interest rate differentials between the U.S. dollar and other currencies.

Imagine that debt and deficit-ridden America has the lowest interest rates in the world! Such a combination is unprecedented. The last time dollar interest rates were lower than foreign rates was in the early 1970s. But then, the United States was the biggest creditor in the world.

And one should also remember that the U.S. had its first current-account deficit in 1971, then amounting to $1.5 billion. Today there is a mountain of foreign liabilities - $2,300 billion gross and $650 billion net - and an annual current account deficit of $100 billion is celebrated as a great achievement that justifies a rising dollar.

DOLLAR: SHORT-TERM INTEREST DIFFERENTIALS	ONE MONTH	3- MONTHS
Britain	-7.11%	-6.53
Canada	-5.05	-4.63
West Germany	-0.46	-0.55
France	-2.28	-2.35
Japan	-0.17	-0.32
Switzerland	-0.23	-0.51

One of the stereotypical arguments put forward in favour of a strong dollar is the expectation of an improving trade and current-account deficit. Although we have already outlined the limitations of an improving trade deficit earlier, we should also point out the impact of the recent oil price hike. At current levels, higher oil prices would again boost the U.S. trade deficit some $9-10 billion back to an annual rate of $110-120 billion. The all-time record deficit was not that much higher at a level of $143.7 billion in 1987, and that amount then had to be financed by foreign central banks since private capital wasn't forthcoming.

CAPITAL DYNAMICS THE KEY

A crucial and incontrovertible fact is that capital movements are affected by a totally different set of influences from those affecting the movements of goods. Theoretically, all through the 1980s, the U.S. current account (which cumulated to a total of $750 billion) had been highly negative for the dollar. Yet, because of favourable world monetary conditions, in six of the ten years surging capital inflows more than compensated for the current account deficiency. The over-financing of the mammoth deficits caused the dollar to soar.

In four of those years - particularly in 1985 to 1987 - the capital account failed to support the dollar. What's most remarkable, though, is that this happened despite the fact that the dollar retained a considerable interest rate advantage against the "hard" currencies. That only happened because Germany and Japan had eased their monetary policies in lock-step with the Fed.

As already said, for the first time ever, the deficit-ridden U.S. economy and the dollar is without the protection of an interest rate shield. Worse than that, it's virtually certain that short-term interest rate differentials will widen further as the Fed is pressured to ease while the Bundesbank and the Bank of Japan may yet have to tighten. We hardly need to point out that currencies are most sensitive to short-term differentials.

As negative as the cyclical and interest rate differential are for the dollar, it's still only part of the story. We must remember that the United States and all the other deficit countries were as babes in a candy store during most of the 1980s as far as world financial markets were concerned. There were no other major borrowers. Germany and particularly Japan readily financed all the deficits. Now, however, changing internal financial and economic conditions of these two countries cut off their formerly huge capital outflows. These countries increasingly need to appropriate their savings for themselves.

The dollar's failure to respond positively to the Middle-East crisis betrays a serious underlying weakness. It is slowly but inexorably dawning on the markets that the sluggishness of the U.S. economy and the risks of a debt and banking crisis prohibit any rise in dollar interest rates even though the oil price hike may demand it. This contrasts weakly with the situation in Japan, Germany and other western countries where strong economies can tolerate unrestrained anti-inflationary policies.

In conclusion, let us say that it as an absolute mystery to us how anybody can expect a strong or even a stable dollar under such conditions: huge foreign indebtedness, a still huge current account deficit, and the lowest interest rates in the world.

THE JAPAN EFFECT

Japan plays an important role as a competitor in the world market for industrial goods but its role in international finance and global financial markets is of much greater importance. Japanese capital outflows - particularly since 1986 - have flooded many overseas markets thus contributing to and exaggerating their bullish up-trends.

Not only did the Japanese international players have a huge domestic savings surplus at their disposal as manifested in Japan's current account surplus, but on top of that they also were given an unlimited credit rating. Japan borrowed heavily in international capital markets with effective interest rates of next to zero by way of warrant bonds and convertible bonds. Much of this loot was invested in other foreign high-yielding bond markets. (See our February letter of this year discussing this topic.)

During 1985-88, total Japanese foreign investments amounted to approximately $665 billion of which around $440 billion found a home in securities . . . mainly bonds. Given these gigantic Japanese purchases of international securities during this period, it goes without saying that the continuation or discontinuation of these capital flows is of great significance for world financial markets.

The Rise . . . Let us briefly explain how Japan's came to international financial dominance. Its rise had three basic foundations: an export surplus in trade with the United States, high domestic savings and a massive money and credit creation propelled by prolonged excessive money growth. As it happened, the excess money found two main outlets: firstly, domestic bonds, stocks and real estate therefore causing their prices to skyrocket . . . the famous asset price inflation; and secondly, capital outflows which played a significant role in fuelling the worldwide speculative mania in financial assets.

Japan, of course, was not alone in staging such monetary excesses. It was a worldwide phenomenon. Actually, first in the chain was America's persistent and gargantuan trade deficit that flooded the rest of the world with hundreds of billions of dollars. In 1987, the collapsing dollar, in turn, coaxed the world's central banks into massive dollar purchases by which they inflated their own domestic money supply. The key to understand is that the spectacular performance of the world's financial markets over the past five years was driven by an unprecedented orchestration of international liquidity creation.

. . . and Fall of Japanese Liquidity. Now, excess liquidity is shrinking rapidly, absorbed partly by monetary tightening and partly by booming economies. Only Japan's central bank kept the monetary spigots wide open until well into last year, resulting in a continued excessive monetary expansion, an incredibly leveraged financial system, continued excessive capital outflows, a weak yen and an overheating economy.

Japan's belated monetary tightening had its first victim in the crashing Tokyo stock market. Meanwhile, another important effect is unfolding in Japan's capital account: investment flows are beginning to stay home or are being repatriated. Recently, Japanese short-term interest rates have overtaken U.S. rates and have almost caught up with German rates. As a result, the yen has strengthened. A rising yen indicates that Japan's huge excess investment flows into the rest of the world's securities markets have suddenly dried up.

As the Japanese economy continues to boom, interest rates will stay high or move even higher meaning that the bull market of the yen against the U.S. dollar will continue. While Japan's export surplus is down sharply, capital outflows are shrinking even faster, for reasons easy to see.

Higher yen rates are not the only reason behind this dramatic tide change in Japanese capital flows. The collapsing Tokyo stock markets and the plunging bond market signal that a pervasive internal liquidity crunch is impacting the capital account. As the previously large outflows of Japanese money into foreign securities ebb, the resultant rise of the yen aggravates the situation further.

All of a sudden financial leverage works in reverse everywhere. The higher yen adds to valuation losses on foreign securities investments, thereby further blemishing the attractiveness of foreign securities. And as such, Japan's illiquid capital situation reverberates into world financial markets.

Bank Liquidity Linked to Stock Market. Symptomatic of the complex consequences are the immediate effects on the overextended Japanese banks whose activity has proliferated around the world. Until recently, they seemed to be immune to any profit and capital problems. Thanks to the long bull market in stocks, their stock portfolios were brim full with unrealized capital gains. Relatively small portfolio sales served to bolster current profits and the capital base. For example, in the year ending March 31, 1990, Dai-Ichi Kangyo, made more than 40% of its profits by taking profits on shares it owned.

With a crashing stock market, this cheap source of profits and fresh capital is now suddenly clogged. Not only that, it cuts directly into their capital base because Japanese banks are allowed to count 45% of their unrealized profits on equity portfolios as capital. As a result, most banks are rapidly falling short of their capital targets. Hence a mounting need to retrench on the one hand and to raise fresh capital from sources other than the stock market.

Just as this letter was going to press, we saw an article in the Financial Times of London (September 12th) which addresses the redirection of Japanese capital flows. Statistics from Japan's Ministry of Finance show that flows between Japan and the United States have already changed with a vengeance.

For the first half of 1990, Japanese purchases of all foreign securities totalled $18 billion, down from $45.3 billion in the same half of last year. That's a drastic slowdown, but the slowdown between the U.S. and Japan is even more dramatic . . . in fact it's a complete reversal. What were heavy Japanese purchases of U.S. securities during the first half of last year reversed into a net divestment of $8.9 billion in the first half of this year.

GERMANY BECOMES CAPITAL HUNGRY

The supply-demand conditions for capital in Germany are changing just as radically as in Japan, but for totally different reasons. Unification has transformed Germany into an immensely capital-hungry country literally over night, thus bringing a new powerful borrower onto the world scene.

The first effect is that German investors have turned their sights inward. During the first seven months of 1990, net purchases of German domestic bonds by residents (not including banks) soared to DM 80 billion compared with only DM 30 billion in the same period of a year ago. Purchases of foreign currency bonds - the great attraction of past years - hurtled toward zero.

Of striking contrast is the behaviour of foreign investors. When unification was announced many of them took flight from the German bond market. In the first quarter, foreigners dumped DM 11.4 billion worth. Since then, though, there has been moderate net-buying.

Much has been written about the ever increasing finances needed to prevent the collapse of the East German economy and its financial system. Most of it has been implied negatively for Germany's bond market and currency. Here some perspective is in order. The total government budget deficit (including the Unity Fund) is now expected to amount to over DM 120 billion both this year and next. How much is that? For a start, it's about 5% of German GNP and a little more than last year's savings and export surplus amounting to DM 104 billion.

Instructive is the U.S. experience in 1983. The U.S. budget deficit then amounted to 5.2% of GNP but in conjunction with an erupting current-account deficit. Yet, the dollar soared for two years. As we all know in hindsight today, it was the mix of tight money and exploding domestic borrowing requirements that sent the dollar through the roof. Given that experience, higher German borrowing requirements can only add to the strength of the D-Mark.

To be sure, Germany's current account surplus will shrink. The key question is whether the reduction will be more or less than the reversal in the German capital account. We haven't the slightest doubt that the capital account effects - falling German outflows and rising inflows - will dominate and thus boost the D-mark over the long run. It all comes down to whether the Bundesbank keeps monetary policy sufficiently tight. Given the robust economy, for us, that's no question.

CONCLUSIONS

Our review of drastically changing international monetary and capital supply\demand conditions leads to the clear denouement that, indeed, "sea changes" are in the offing for international capital flows and currencies, reversing the trends of the last decade.

Given the dominant role that international capital flows have played in financial and currency markets during the last decade, the disregard that this influence finds in the currency debates is flabbergasting. Obviously, many people - including numerous experts - have yet to awaken.

In view of the unprecedented size of the international imbalances and the potential dimensions of impending changes in capital flows - in fact even reversals - we must conclude that currency trends are vulnerable to virtually unlimited exaggerations.

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